DOW THEORY LETTERS INC.

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"I place economy among the first and most important virtues, and public debt as the greatest of dangers to be feared.....To preserve our independence, we must not let our rulers load us with public debt.....We must make our choice between economy and liberty or profusion and servitude." (Thomas Jefferson)

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THE MARKET: On Monday, July 25, the Industrial Average plunged under its May 17 (864.14) bear market low to close at a new low for the year. On July 26, as further weakness enveloped the market, the Rails confirmed by closing fractionally below their own 1966 low of 220.54. The joint new 1966 lows in the Averages mean that the bear market is now on its third primary (downward) leg. The third leg started at the mid-June rally highs of 903.22 for Industrials, 232.33 for Rails. At the July 26 lows the Averages had been down seven days in a row, and the market was probably temporarily oversold. A rally started on July 27, and this rally may serve to correct some of the downside compression of the past week or so.

"How long could this third primary leg last?" I have been asked. The answer is that I haven't the slightest idea. But I do believe that we are gradually approaching the panic stage of this bear market. I feel that if the 1965 Industrial low of 840.59 is violated, almost everyone will then finally admit that a bear market is in force. This belated recognition could signal a general "rush for the exits", a rush which I have sincerely wanted all my subscribers to avoid. A panic drop under the 840.59 level could be accompanied by liquidation, margin calls, fear, confusion and bankruptcies. Such action can only end one way for the market--it must end in utter downside exhaustion.

Bear markets tend to be subject to three distinct psychological phases. In the first phase (and these phases should not be confused with price movements) the market sells minus the froth and enthusiasm of the preceding bull market's final speculative phase. During this first phase of a bear market, the public is still optimistic and bullish. Many people continue to hold stocks in the secret hope that new highs will still be forthcoming. They are not yet willing to accept the bear thesis. I believe that at present we are still in the first phase of this bear market. However, we are rapidly approaching a period of possible downside panic. If and when this occurs, I would say that we would be entering the second phase of the bear market.

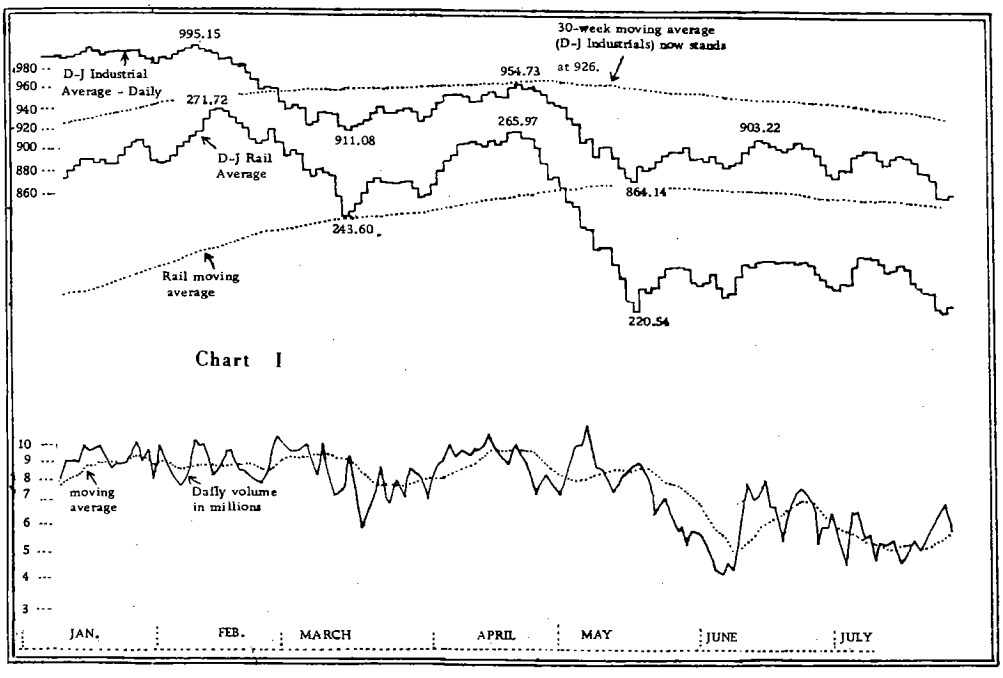
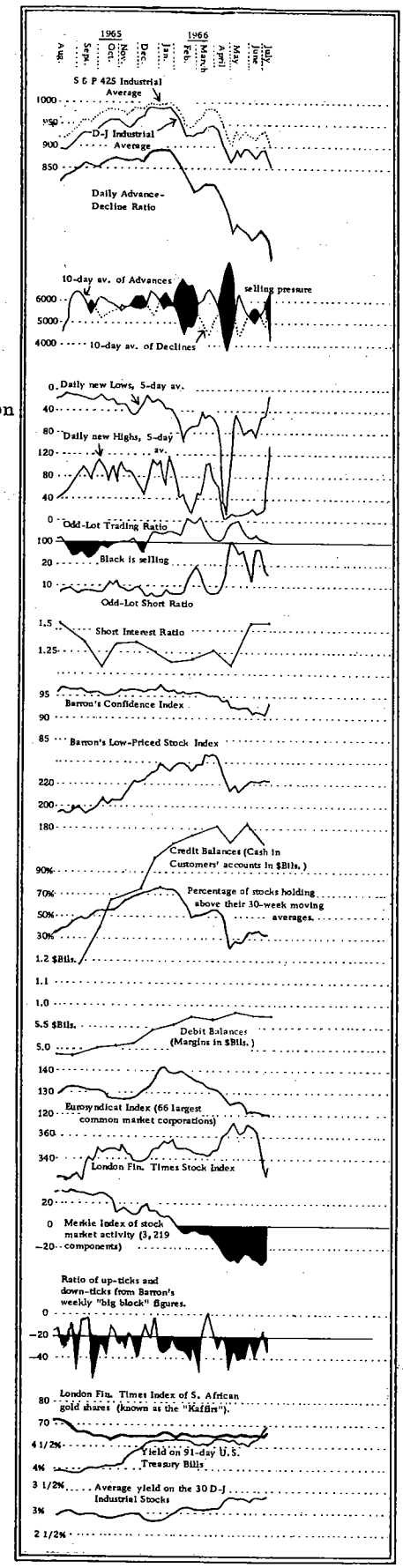


Chart I



The second psychological phase of a bear market is usually the longest phase. During the second phase the public finally turns bearish and the market discounts the obviously deteriorating economic situation. The second phase of a bear market is usually accompanied by broad panic-type action. This phase is often terminated by a particularly deceptive and violent upward correction. It would not surprise me to see this bear market move into the second (panic) phase during the several weeks ahead. I believe the second phase could last for many months, taking the Dow down to perhaps (and this is a sheer guess) the 690-700 area (see Letter 323 in which I offered my best "educated" guess as to what might lie ahead).

SECRETS OF A WRITER: In May, 1936, Robert Rhea (one of the great Dow Theorists) wrote: "When people ask, 'should I buy or sell stocks now?', and I reply, 'I haven't the slightest idea and only wish I knew,' they think I am holding out some inside information on them. While there are rare times when I feel absolutely confident of a position, about 80% of my own days are spent in perplexity."

NOTES AND QUOTES: From the July, 1966 Monetary Report by Alden Wells: "Gold, we believe, is the only evidence of wealth that can be accurately described as capital. All the rest is institutional paper. The paper is necessary in any society above the barter stage, but its rules must be obeyed. These rules are known to any banker, although he can easily lose sight of them. The acid test of a sound economy is whether it is gaining or losing gold. A loss is proof that the institutionalized paper is being used for selfish ends by persons given responsibility for governing. Obviously, governments losing gold reject any such analysis."

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The accompanying clip tells of the new bill which will seek to subsidize closed gold mines to the tune of $47 per ounce for each ounce of gold produced. Currently-producing mines would receive an extra 6%. This would amount to a three-price system for gold with the highest price being $79 per ounce. The Treasury will almost certainly interfere to kill this bill before it passes through Congress, but it does show that an influential group of individuals are thinking of gold in terms of an ultimate price of around $80 per ounce. This type of thinking is long-term bullish for the golds.

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Ever since the big escalation of the Vietnam war I have been writing that this war is part of the main Communist strategy of defeating the U.S. not militarily--but economically. In Letter 314 I quoted from a Canadian newsman who told how Mao Tse-tung followed the U.S. stock market daily while waiting ".....the first signs of the coming depression." I have not changed my mind one iota about the Communist strategy, and I have felt all along that Vietnam was as stupid a business as anything the U.S. could have entered from a purely economic standpoint. Along these lines, I found the enclosed United Press clipping most interesting. Hanoi, perhaps briefed by China, also sees the war as based in economics. I personally doubt very much if Hanoi will be willing to "settle" while a bear market is on in the U.S. After all, why should they? Time would appear to be on their side. An economic slump here would place tremendous pressure on this nation to bring this fantastically costly war to a close.

* * * *

For years we have been told that "they" wouldn't let a bear market occur. Our nation was running at white heat, guided by the "New Economics." How could the market collapse in the face of the managed economy? Nevertheless, a few people are cynical enough to suggest that the economy has been mis-managed. "Economics is supply and demand," wrote the late Bernard Baruch, "all the rest is the bunk." But our economists and politicians have attempted for decades to manipulate the laws of supply and demand. In so doing, they have built a top-heavy, debt-ridden economic monster. Now the monster is sick, and it is toppling over.

The monster had a bad heart attack in 1962, but it recovered. In 1965 it had a second heart attack, and again it staggered to its feet. Now, in 1966, the sickness has permeated its system, and it is falling. Its fall is calculated to crush many hapless people; politicians, investors and innocent bystanders alike. That's what happens when mighty monsters die.

But the professionals, the investment services, the Wall Street leaders; how could so many of them have been so bullish and so wrong? It was simple. They did not really believe that a bear market started in February, 1966. They did not know (having little or no experience with bear markets), that when the great tidal force of the market turns down, the bull is dead. Always before, following steep declines, the market has subsequently pushed up into new high territory. The February-May, 1966 decline seemed steep enough. The May 17 lows looked secure enough. Why not sit back and wait for the big rally?

Perhaps 20% of the readers of these Letters have lived through an extended bear market, and most of those have forgotten what it was really like. But this market is doing what a bear market is supposed to do. When the March-April rally fizzled out, the Averages turned down and broke to new lows. Then when the May-June rally exhausted itself, the Averages suddenly turned down again. To understand what is happening requires only one piece of information and one frame of reference; a primary bear market is in effect. And it is calculated to be a big one and a severe one.

GOLD SUBSIDY BILL BACKED

WASHINGTON — (AP) — The House Interior Committee yesterday approved a bill calling for a $50 million annual subsidy for domestic gold mines.

The measure is designed to keep present gold mines operating and to reopen closed mines.

Operating mines would be given payments equal to 6 per cent of the gold they produced the previous year. Qualifying operators of closed mines would get subsidies of $44 an ounce above the $35 government price set in 1939.

The 125 per cent subsidy would go to those companies able to prove their operating costs had increased that much since 1939.

WAR HURTS U.S.-HANOI

TOKYO (UPI) — Radio Hanoi yesterday said the United States is being forced into bankruptcy by the Viet Nam war. It quoted at length from U.S. congressmen and American and world newspapers in an attempt to prove it.

The broadcast said the war has forced the United States to "cannibalize" its military forces all over the world, brought about logistical problems and created dissention at home.

It said the United States has used every weapon in its non-nuclear arsenal and has succeeded only in increasing taxes, causing inflation in South Viet Nam and making itself a debtor.

I often reread Rhea's works and especially his market service which was written over a period of 7 years during the 1930's. Anyone who has had to write a market letter alone (as I have) must feel a bit helpless as he faces the enigma that is Wall Street, month after month and year after year. It's the toughest business in the world, and for one simple reason. The market writer must pit his art, his knowledge and his intuition against the smartest and most intelligent money in the world. Rhea wrote that "80%" of his days were spent in perplexity. I sometimes feel that my own days of perplexity are nearer the 90% level.

Nevertheless, there are times when most of the evidence stacks up overwhelmingly one way or the other. Those are the dramatic times, and they are the difficult times. They are difficult for me because it is then that I have to eliminate all the "buts, if's, maybe's, and perhaps's" and take a stand for my subscribers. If I do not state my opinion directly and without equivocation, then my opinion loses its forcefulness and subscribers are apt to disregard it. But I have learned one thing, and that is that when an opinion is most important and most correct, it seems most "impossible" and most "dangerous" in the light of current conditions.

I learned this lesson thoroughly in 1957, and I will never forget it. In 1957, following the July-October market cave-in and the gathering business recession, pessimism was so thick you could cut it with a knife. People were angry with me when I talked about a coming stock market and business boom. The bull side was actually unpopular during 1957 and 1958. I'll never forget the day in December 1957 when the President of the Columbia University Business College issued a forecast to the effect that "the post-war depression" was finally upon us. I was loaded with stocks, at the time, and in fact I was up to my neck on margin (I have

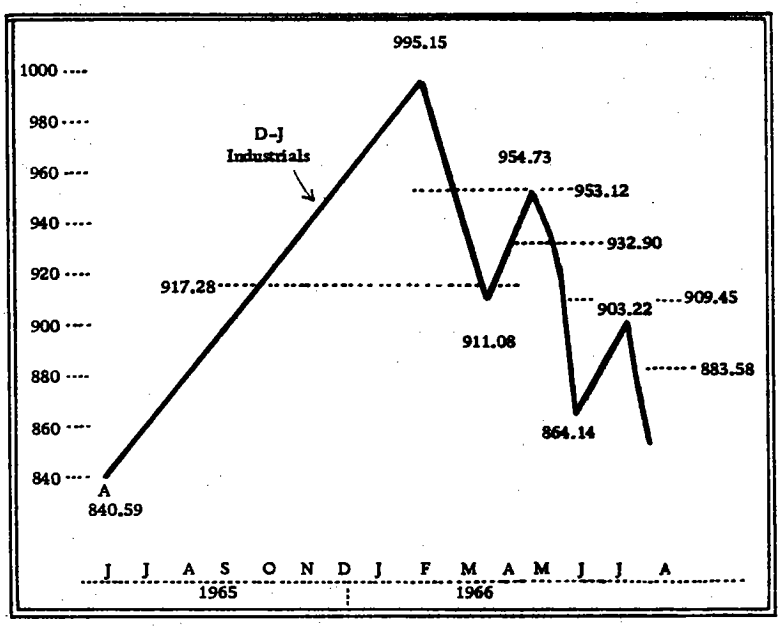
never done that again). That evening I told my wife, "I haven't had a good night's sleep in two weeks, but I know I'm right and the bears are wrong. But if I'm wrong, if all my studies prove to be wrong, I'm going to give up this business. And I'll never put another penny in Wall Street." That was prior to one of the greatest and most profitable upswings in the history of the stock market. It was a dramatic instance of the great majority of professional, banking, university and public opinion being dead wrong.

I wrote my first article for Barron's on December 1, 1958. The rise in the market was relentless, people were still coldly bearish, and the Barron's article presented the bull market thesis. The article created a great deal of interest, and it was of considerable help in launching my service. Many of Robert Rhea's old subscribers wrote me during the months that followed and many subscribed to my service. Those of us who bought stocks during 1957 and 1958 did very well indeed. But I will never forget the extreme pessimism of those days, I will never forget that almost everyone was wrong, and I will never forget that the weight of evidence was bullish for the market, despite the doubts of perhaps 99% of the country.

I felt the same way when I wrote Letter 323 recently, in which I took one of the strongest positions in the investment field to the effect that the time had come to get out of the market. I had been cautious all during the first quarter of 1966, but when the bear signal of May 5 arrived, I took my stand. My bearishness was so at variance with prevailing opinion that NEWSWEEK magazine twice quoted me (March 28, 1966 and May 16, 1966), perhaps because they wanted to present both sides and there were so few analysts around to provide the bear argument.

When I wrote my "bear signal Letter" (number 323) I told my wife, "There's no hedging this time. I know my subscribers tend to be more liquid than perhaps any other group of advisory service readers in the country. I can't put it any more forcefully. If the market goes to new highs, then it's not a bear market, and I will have been dead wrong. But if I'm right and if most of the nation and Wall Street is wrong, then we'll have saved several thousands of our subscribers from losses, margin calls, sleepless nights and that ghastly, sinking feeling of being caught with their life's savings in a primary bear market." It's a lonely business writing my type of market Letter. People often ask me what I think about and worry about. Maybe the foregoing will give my subscribers an insight as to what goes on in my mind.

50% PRINCIPLE: I last discussed the 50% Principle in Letter 322. The Principle states that any broad market movement can be likened to the movement of a child's see-saw. Picture a child standing at one end of his see-saw. That end is in the high position. He presses down on the see-saw. His end descends while the opposite end of the board rises. If the push has been gentle, then the board hesitates near the horizontal or halfway level, then returns to its original position with the end nearest the child in the high position again. But if the child pushes down on the see-saw hard enough, then the see-saw moves past the horizontal level and the end near the child touches the ground while the far end rises to the high position. In other words, it is the amount of force applied which determines whether the see-saw passes the horizontal position (50% level). If the board does pass the 50% level, the force continues and the board's position is reversed.



In the light of the 50% Principle as described above, let us examine the action of the D-J Industrial Average over the past year (see accompanying chart). The rise from the June, 1965 low of 840.59 to the all-time high of 995.15 (February, 1966) was tested on the first 1966 decline. The halfway level of the 840.59 to 995.15 advance was 917.28. In May, 1966 the Industrials plunged to 911.08, thereby violating the 917.28 halfway level. This was bearish, and Letter 322 discussed the implications of this violation. Under the 50% Principle, it was now a strong possibility that the Dow would ultimately test the lower level of the 1965-1966 rise (i.e. the 840 area).

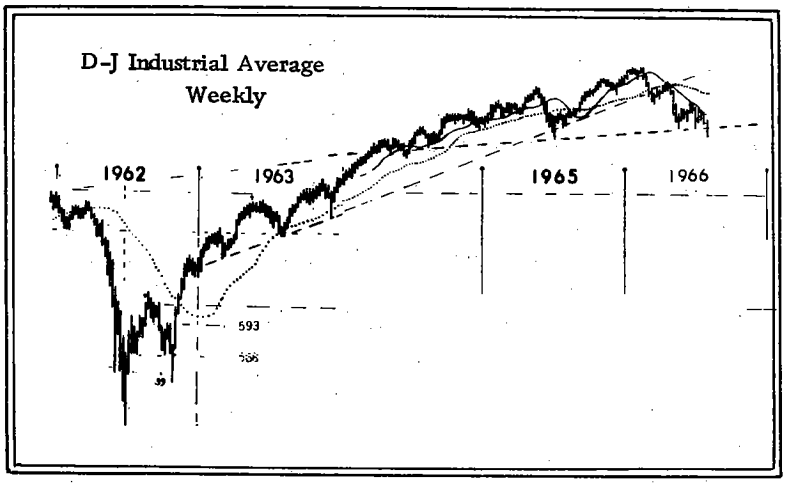
During March and April a rally took place, and here the important point was the halfway level of the preceding February to May decline (995.15 to 911.08). That halfway level was 953.12. On April 21, for a single day, the Dow pushed to 954.73, just one point above the halfway level. But a new decline started the very next day, and the new decline took Industrials to a 1966 low of 864.14.

The halfway level of the April-May decline (954.73 to 864.14) was 909.45. The next test was whether the Dow could better 909.45 during any rally. From the May 17 low of 864.14 a new advance carried Industrials to a June high of 903.22, just six points below the halfway level. So far, the progress of the Dow under the 50% Principle remains bearish. In other words, on

 decline the Dow has repeatedly broken preceding halfway levels, but on advances the Dow has been unable to regain 50% of the previous decline.

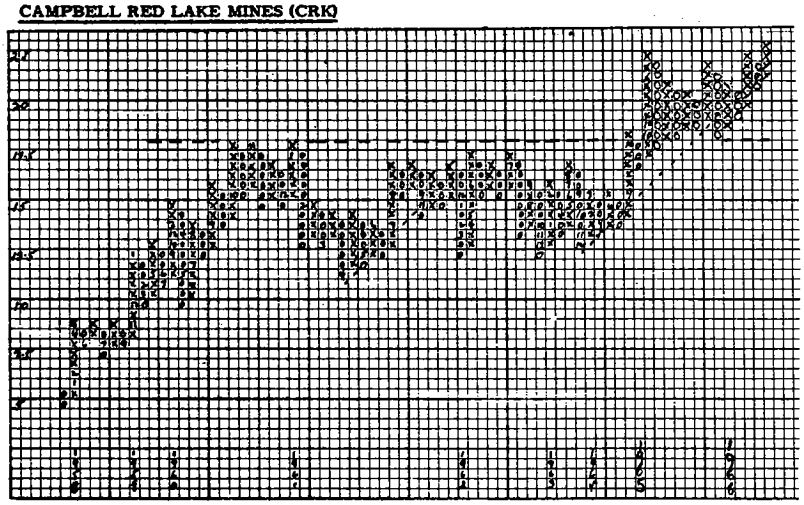
On July 25 the Industrials closed below their 1966 low of 864.14. The next potential move could be a testing of the halfway level of the entire 1962 (535.76) to 1966 (995.15) advance, a total rise of 459.40 points. The halfway level of the 1962 to 1966 advance is 765.46. If, on any forthcoming decline, the Dow breaks below the 765.46 level, the 50% Principle will be saying that there is a good chance that the Dow will ultimately probe the 1962 low area around 535.76.

BIG PICTURE: The accompanying weekly chart of the D-J Industrial Average covers the period of 1962 to date (chart courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kan.). The ominous picture shown on this chart is almost self-explanatory. Distribution in the Dow stocks began in late 1964 and early 1965. Thus the whole 1964-early 1965 price movement appears to form a hugh left shoulder (of a head-and-shoulders top) on the Dow. The big advance into 1965, although highly selective, served to form the head. Finally, the weak right shoulder was formed during May and June of 1966. The break last week to the low 850's took the Dow below the long dashed neckline. All and all, it is not a pretty picture. While the Dow might now "pull back" and retrace part of the recent drop from the June high, the chart suggests that we could be nearing a most dangerous part of the bear market. Remember, the longer the elapsed time, the greater the strength of the bear forces during a primary bear market. I urge my subscribers to stay out of "bullish looking" (bear market) rallies. This market is (and continues to be) one of the most deceptive bear markets I have seen.



STOCKS: Campbell Red Lake Mines is one of the leading gold producers of Canada. I have been recommending the stock repeatedly for almost three years. The stock rose last week to an all time high of 26 3/8, and it is now worth examining CRK in more detail.

CAMPBELL RED LAKE MINES (CRK)



The point-and-figure chart (courtesy of Chartcraft, Larchmont, N.Y.) shows eight years of action in CRK. All movement under 20 is shown in half-point (each vertical box equals a half point), all action of 20 or above is one point (each vertical box equals a whole point). Only reversals of three points or more are charted (X's are rallies, O's are declines). CRK touched 18 in 1960, then broke down to record an extreme low of 11½ in 1961. During late 1961 and 1962 CRK rose to the 17½ area again, only to drop in late 1962. By late 1964 it became apparent that all the action of CRK from 1961 to 1964 was taking on the appearance of a massive base. The "base thesis" was validated by the action during 1964. In October, 1964 CRK pushed above the old 18 top, then rose to an all-time high of 25 in 1965. A new structure began forming during the 1965-66 period with a new base at 18. In May of 1966 CRK again touched the 25 level, then dropped back to widen the new base. Finally, this month CRK rallied to its all-time high of 26 3/8. Based on the long horizontal base built during 1961 to 1964 and based on the new higher base of 1965-66, the price objective for CRK would appear to be at least into the mid-30's. If the movement in the gold group is a primary bull movement (which I believe it is), then CRK should carry further than its ordinary "upside objective." I recommend purchase of CRK for all subscribers. (Note: Dow Theory Letters, Inc. has a small position in CRK).

U.S.STEEL: Bear markets are tragic affairs. Take the example of mighty U.S. Steel. This stock touched a record high of 108 in 1959. Since then it has been steadily dropping. Recently, in the 43-44 area, Steel began attracting attention, and it was said that the funds were accumulating some of the leading steels. But with the most recent sell-off in the market, Steel broke its "base" 42½ and sank into the 41 area. In the last 12 years the lowest Steel has been is its 1962 low price of 38. If Steel breaks below 38 on any forthcoming decline, it will drop to its lowest price since the early 1950's. Those who have seen their investment in Steel drop from 108 to 41 must wonder what Wall Street is all about. Steel has been in a major bear market since 1959. Its drop has been catastrophic. Is there anyone in 1959 who could have believed that Steel would lose almost two-thirds of its value in the next seven years? CONCLUSION: When a stock forms a major top and breaks down, it is time to get out. By the same token, when a major bear market appears to be underway on the New York Stock Exchange, the best thing to do is sell out.